Nos. 17,823 and 17,836-17,841

In the United States Court of Appeals for the Ninth Circuit

F. C. VAUGHAN and MATTIE VAUGHAN, ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petitions For Review of the Decisions of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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INDEX

	Page
Opinion Below	1
Jurisdiction	1
Question Presented	2
Statutes and Other Authorities Involved	2
Statement	2
Summary of Argument	10
Argument:	
There was substantial evidence to support the Tax Court's determination that the heifers in taxpayers' herd twenty-four months of age or younger were under the particular circumstances here involved held primarily for sale to customers in the ordinary course of taxpayers' beef cattle operations	12
Conclusion	27
Appendix	29

CITATIONS

Cases:

Albright v. *United States*, 173 F. 2d 339 ... 14, 21, 25
Bartlett v. *Commissioner*, decided September 22, 1955 (P-H Memo T.C., par. 55,259) ... 25
Biltmore Co. v. *United States*, 228 F. 2d 9 ... 20
Clark v. *Commissioner*, 27 T.C. 1006 ... 19
Cole v. *United States*, 138 F. Supp. 186 ... 18
Deseret Livestock Co. v. *Commissioner*, decided March 25, 1953 (P.H Memo T.C., par. 53,093) ... 24
Emerson v. *Commissioner*, 12 T.C. 875 ... 14
Fawn Lake Ranch Co. v. *Commissioner*, 12 T.C. 1139 ... 14
Flato v. *Commissioner*, 14 T.C. 1241 ... 14
Fox v. *Commissioner*, 198 F. 2d 719 ... 15, 16, 20
Gotfredson v. *Commissioner*, 217 F. 2d 673 ... 15, 16, 20
Grace Bros. v. *Commissioner*, 173 F. 2d 170 ... 23

Cases—Continued Page

Greer v. *Commissioner*, 17 T.C. 965 20
Harder v. *United States*, decided February 17, 1959 (59-1 U.S.T.C., par. 9364) 25
Hatch's Estate v. *Commissioner*, 198 F. 2d 26 24
Kline v. *Commissioner*, 15 T.C. 998 14
McDonald v. *Commissioner*, 214 F. 2d 341 .... 19, 21
Miller v. *United States*, 98 F. Supp. 948 21
O'Neill v. *United States*, decided June 16, 1952 (52-2 U.S.T.C., par. 9462), affirmed *per curiam*, 211 F. 2d 701 22
Pfister v. *United States*, 102 F. Supp. 640 21
Smith, Estate of v. *Commissioner*, 23 T.C. 690 22
United States v. *Bennett*, 186 F. 2d 407 .... 14, 21, 25
United States v. *O'Neill*, 211 F. 2d 701 .... 16, 25
United States v. *Pfister*, 205 F. 2d 538 21
Vaughan v. *Commissioner*, 36 T.C. 350 1
Watson v. *Commissioner*, 345 U.S. 544 24
Williams v. *McGowan*, 152 F. 2d 570 24

Statutes:

Internal Revenue Code of 1939, Sec. 117 (26 U.S.C. 1952 ed., Sec. 117) 13, 29
Internal Revenue Code of 1954, Sec. 1245 (26 U.S.C. 1958 ed., Sec. 1245) 26
Revenue Act of 1951, c. 521, 65 Stat. 452, Sec. 324 30

Miscellaneous:

I.T. 3712, 1945 Cum. Bull. 176 .... 25, 26
Mim. 6660, 1951-2 Cum. Bull. 60 .... 15, 26
Mim. 6776, 1952-1 Cum. Bull. 71 .... 15, 26
S. Rep. No. 781, 82d Cong., 1st Sess., pp. 41-42 (1951-2 Cum. Bull. 458, 487-488) 34
Surrey and Warren, Federal Income Taxation (1954), p. 528 13
Treasury Regulations 111:
Sec. 29.23(l)-10 26
Sec. 29.117-7 31

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (R.430-454) are officially reported in 36 T.C. 350.

JURISDICTION

These petitions for review (R.482-521) involve federal income taxes for the taxable years 1948 to 1951, inclusive. Notices of deficiencies were mailed by the Commissioner of Internal Revenue to the taxpayers on December 29, 1954, and on June 19, 1957.

(R. 31,36.) Within ninety days thereafter (on March 25, 1955, and September 16, 1957, respectively), the taxpayers filed petitions with the Tax Court for redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939 (R. 4-30, 36-53). The cases were consolidated for trial (R. 535, 538) and the decisions of the Tax Court were entered on October 4 and 5, 1961 (R. 466,475-481). The consolidated cases (R.2) are brought to this Court by petitions for review filed on December 29, 1961 (R. 482-521), within the three-month period prescribed by Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of the Code.

QUESTION PRESENTED

Whether there was substantial evidence to support the Tax Court's determination that the heifers in taxpayers' herd of cattle twenty-four months of age or younger were not, under the particular circumstances here involved, held for breeding purposes within the meaning of Section 117(j)(1) of the 1939 Code, so that the gain derived from the sale of the heifers constituted ordinary income, not capital gain.

STATUTES AND OTHER AUTHORITIES INVOLVED

These are set forth in the Appendix, *infra.*

STATEMENT

The Tax Court's findings of fact (R. 433-445) based upon a stipulation (R. 56-77) with exhibits

nd extensive testimony (R. 125-429), may be summarized as follows:

The taxpayers are F. C. Vaughan and his two sons, Floyd C. and P. W. Vaughan. In 1940, they organized a partnership known as Vaughan Bros. for the purpose of operating a cattle ranch near Bruneau, Owyhee County, Idaho. Vaughan Bros. owned in fee simple about 3,600 acres of land and held grazing rights from the federal and state governments on approximately 250,000 acres. The partnership operated the ranch and conducted livestock operations continuously from 1940 to May, 1945, when it contracted to sell the ranch, range rights and cattle. The purchasers undertook operation of the ranch and sold a part of the cattle. However, because of difficulties encountered in obtaining financing, the sale was rescinded with the partnership's consent, and the ranch, range rights and remaining portion of the herd were returned to Vaughan Bros. in October, 1945. (R. 433.)

In May, 1946, Vaughan sold the ranch, rangeland and range rights to Milford J. Vaught (hereinafter referred to as "Milford"). Since Milford was unable and unwilling to purchase the cattle then on the range properties he had just purchased at the price asked, he entered into, about the same time, a "lease agreement" with F. C. and Floyd C. Vaughan as lessors whereby Milford and his wife, as lessees, undertook to "operate" the cattle for a five-year period ending April 1, 1951, on such properties. (R. 434-435.)

The agreement recited that the lessors, who were the owners of certain branded Hereford cattle (classified as to cows, heifers, calves and bulls) and Milford contemplated the "operation of the cattle," together with any increase and accretion thereto, as "an operating cattle unit" in connection with the described range and properties. (R. 434.)

Under the terms of the agreement, the Vaughans leased and let to the lessees the cattle, replacements, and increase, title to which remained in the Vaughans (except for cattle sold) for operation by the lessees for the five-year term. No partnership was intended; neither party was to be liable for the debts of the other, and Milford was to operate as an independent contractor. Milford agreed to care for and operate the herd as a unit and to maintain it at its initial size and quality by increase, or by purchased replacements paid for jointly by the parties. Range fees and costs of bulls for the herd were to be borne equally by the parties; Milford agreed to furnish all feed and labor necessary for operation of the herd and to pay all operating expenses. No cattle were to be removed from the county "except in the normal course of the marketing of the beef and other cattle which shall be produced for sale or which in the normal operation of said herd should be sold from the culling thereof." (R. 434-436.)

The parties each were to receive one-half of the proceeds from the sale of cattle produced from the herd. Milford, under the agreement, was authorized to sell and market cattle from the herd as were pro-

duced for market, as he judged to be in the interest of the parties; however, he was to confer and counsel with the Vaughans in this regard. Checks and drafts in payment of sales were to be made payable jointly to F. C. Vaughan and Milford. (R. 436.)

Upon termination of the agreement, the Vaughans were to receive replacement of the herd in the amounts and classes of cattle listed in the agreement. Any surplus cattle were to be divided equally between the parties. (R. 436.)

The cattle delivered to Milford under the agreement were as follows (R. 434):

790	range cows.
306	heifers coming two years old.
102	weaner calves.
128	heifers,
156	sucking calves.
11	registered bulls, 2 years old.
3	registered bulls, 3 years old.
4	registered bulls, 4 years old.
7	registered bulls, 5 years old.
13	aged bulls.
1, 520	total

At the time Milford undertook to operate the Vaughan herd, the range and grazing rights allowed for the grazing of about 2,100 head of count cattle,[1] although Milford subsequently received permission to graze additional count cattle on the federal grazing lands. Count cattle taken over by Milford in 1946 totalled 1,364 animals. There were 1,837 ani-

[1] Count cattle include all cattle except calves less than six months of age on January 1 of the year for which the federal grazing permit is issued. (R. 437.)

mals on hand at the close of the term in 1951. (R. 437, 440, 444.)

During the taxable years in issue, the cycle of operation of the herd commenced about March 15, when dry cows, cows with sucking calves, weaner heifers, older heifers and steers were turned out on the range. "Calvy" heifers and cows were held a bit longer before they were turned out on the range with the rest of the herd. The herd bulls were not turned out until about May 1. The range was an "open" range as distinguished from a fenced range or irrigated pasture operation. Heifers could not be segregated from the rest of the herd. (R. 437-438.)

All cattle remained on the open range until November 15. During this period, all cows and heifers were exposed to the herd bulls. Heifers normally begin to breed when 14 to 15 months old, although on rare occasions they are capable of breeding at 8 or 9 months of age. With a gestation period of 9 months' duration, few heifers drop calves before reaching the age of 24 months. Furthermore, the characteristics upon which a determination is made as to whether a heifer will be valuable as a replacement in the herd do not develop until the heifer is 18 to 24 months old. (R. 438-439.)

In June of each year, a calf roundup took place, at which time calves were located and branded. In August or September, when the cattle were in best condition, the beef roundup occurred for the purpose of selecting the animals intended for sale as beef cattle. Not all animals were gathered in the beef roundup.

Good cows, particularly those obviously with calf, were not rounded up. Many cows, however, were gathered; more, in fact, than were intended for sale. Practically all the heifers were gathered, as were all the steers. Either F. C. or Floyd C. Vaughan was present at the beef roundup during each year Milford operated the herd. (R. 438, 440.)

After the cattle had been gathered and the unbranded calves branded and returned to the range, the steers, cows and heifers were segregated in separate pastures. The number, weight and approximate market price of the steers were calculated. Then there were culled from the cows those animals less desirable for retention in the herd that were to be sold. Next, enough heifers were selected for sale which, with the proceeds from the sale of the steers, would produce sufficient income for continued operations by Milford. Heifers which were obviously pregnant were placed in the breeding herd because buyers of feeder cattle would not buy them. The pregnancy of heifers became apparent in about the seventh month of the gestation period. (439.)

Up to 95% of all yearly sales took place in September or October of each year, and most of them were made to buyers who came to the ranch; the rest of the cattle were shipped to markets in Idaho. (R. 439.)

From then until February of the following year, all the cattle were gathered from the open range for winter quartering and the cattle were segregated by classes, the bulls being separated from the heifers and

cows during March and April. The cycle ended with the birth of most calves in February and March. (R. 439-440.)

During the taxable years in issue, bulls, cows and heifers were sold from the Vaughan herd, as well as steers. (R. 441, 442.)

In order to permit Milford sufficient funds to operate the herd, the following sales of heifers occurred during the term of the agreement (R. 439, 442):

Year	Number	Age in Months	
		Over	Not Over
1946	133	24	28
1947	135	24	36
	1	Not shown by record	
1948	94	18	24
	1	12	15
	1	Not shown by record	
1949	206	15	18
	1	10	12
1950	89	14	18
	99	18	24
	53	12	15
	1	18	22
	1	17	20
	2	24	28
Total	817		

In 1948, heifer sales constituted approximately 20% of total sales and 30% of steer sales. For 1949, these percentages were 28% and 62%, respectively; in 1950, they were 37% and 75%, respectively. (R. 442.)

During the contract period the number of heifers branded totaled approximately 1,636 animals. (R. 442.)

At the termination of the agreement on April 1, 1951, Vaughan Bros. did not have sufficient facilities to accommodate the replacement herd, together with the share of increase to which it was entitled, and it was unable to reach an agreement with Milford for continued operation of the herd. Selection of the replacement herd and division of the increase took place during the first quarter of 1951. The partnership, during the first four months of the same year, sold to Milford one group of 170 heifers ranging in age from 12 to 18 months, and another group of 50 heifers ranging in age from 20 to 24 months. Of a certain number of cattle removed to Oregon in 1951 at, or in anticipation of, the expiration of the contract with Milford, the partnership sold a third group of 60 heifers ranging in age from 12 to 15 months, to Robert F. Vaughan. (R. 443-445.)

The Commissioner asserted deficiencies in income taxes against the taxpayers for the years involved based upon a determination that the gain derived from the sales of all animals during the term of the "lease agreement" should be treated as ordinary income. In the Tax Court, the Commissioner argued that the "lease agreement" created a lessor-lessee relationship between the taxpayers and Milford, so that the income derived by the partnership was ordinary rental income. Alternatively, the Commissioner argued that the animals were not held for breeding purposes, but for sale to customers in the ordinary course of taxpayers' business and that the gain derived from the sales thereof was likewise ordinary

income. The Tax Court rejected the first argument of the Commissioner; however, it decided that all bulls, cows, and heifers over 24 months of age had been held by the partnership for breeding purposes, and hence capital gain treatment was permitted with respect to the proceeds from the sale of such animals. As to these sales, there is now no issue before this Court.[2] The Tax Court further held that the proceeds from the sales of all heifers 24 months of age or younger should be treated as ordinary income since such heifers were held primarily for sale to customers in the ordinary course of business. (R. 446-454.) From this latter ruling, the taxpayers have brought their respective petitions for review. (R. 482-521.)

SUMMARY OF ARGUMENT

During the years in issue, the taxpayers were in the business of raising cattle for sale in the beef market. The animals actually sold in the market included a substantial number of heifers as well as steers. The sale of these heifers was necessary each Fall in order to provide the manager of taxpayers' herd with sufficient operating funds for the coming year.

The provisions of the Revenue Code here pertinent provide that gain on the sale of livestock is to be treated as capital gain if such livestock is held by the particular taxpayer for draft, breeding, or dairy purposes. If, on the other hand, the livestock is held

[2] Sales of steers were never in issue since, by definition, a steer cannot be held for breeding purposes.

primarily for sale to customers in the ordinary course of the taxpayer's trade or business the gain is ordinary income.

The issue here presented is one of fact. The Tax Court's conclusion, based upon the facts of record, that only those heifers over 24 months of age were held for breeding purposes is correct. The record shows that until they reached that age, they had not been introduced into the breeding herd. Heifers below that age were not culled from the herd and sold because they were undesirable for breeding. In fact, whether or not they would be valuable as replacements in the breeding herd could not be known until they were 18 to 24 months old. Younger heifers that were sold in the beef market were selected according to their value to beef cattle buyers. These buyers were not interested in buying heifers that were pregnant, and the fact of their purchases is strong evidence that taxpayers' heifers were not pregnant at the time of their sale. Thus the incidental exposure of taxpayers' heifers to the bulls on the open range does not establish that the heifers had been introduced into the breeding herd.

At the conclusion of their agreement with the manager of the herd, the taxpayers had to sell part of their heifers because they did not have sufficient rangeland to sustain them. These heifers also had been held primarily for sale as beef cattle since they had not reached the age of 24 months. While the immediate reason for sale was the unavailability of grazing land, it is clear that prior to sale they were

not held for breeding purposes. Like the steers which were sold earlier, they were a part of taxpayers' money crop. That a partial reduction of the herd was necessary does not convert into capital gain what is in fact ordinary income.

The Tax Court's division of the heifers according to their ages at the time of sale is supported by the decisions. Moreover, the age selected was reasonable because until that time most of the heifers could not normally produce calves. In addition, the characteristics for determining whether a particular animal would be valuable as a replacement in the breeding herd did not develop until that time. In the absence of sufficient evidence to show the purpose for which each animal was held, the method employed by the Tax Court for determining which animals were held for breeding purposes and which were held for sale in the ordinary course is clearly correct.

ARGUMENT

There Was Substantial Evidence To Support The Tax Court's Determination That The Heifers In Taxpayers' Herd Twenty-four Months Of Age Or Younger Were Under The Particular Circumstances Here Involved Held Primarily For Sale To Customers In The Ordinary Course of Taxpayers' Beef Cattle Operations

The single issue in this case is whether the gain derived from the sale of heifers twenty-four months of age or younger owned by the taxpayers should be reported as capital gain or as ordinary income. Before turning to the basic facts, it will be helpful to review briefly the pertinent statutory provisions and

the situations in which they were intended to apply.

Section 117(a) of the Internal Revenue Code of 1939 (Appendix, *infra*) expressly excluded from the definition of "capital assets" property held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business, as well as depreciable property used in the trade or business. In the Revenut Act of 1942, c. 619, 56 Stat. 798, Section 151(b), the Congress added Section 117(j) (Appendix, *infra*) to the Code. This provision afforded special treatment in situations where recognized gains on the sale or exchange of "property used in the trade or business" exceeded the recognized losses from such sales or exchanges. The gains were treated as capital gains even though the assets were not "capital assets" within the meaning of Section 117(a). Where the net result was a loss, however, it was treated as an ordinary loss. Significantly, Section 117(j) was drafted so as to exclude from the definition of "property used in the trade or business" any property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. As a result, the gain on these latter sales is treated as ordinary income. The net effect of Section 117(a) and (j) is to permit capital gain on the sale of property used in the trade or business unless such property is held primarily for sale to customers. Surrey and Warren, Federal Income Taxation (1954), p. 528.

For several years after the enactment of Section 117(j), there was considerable dispute whether all livestock held for draft, dairy or breeding purposes

was property used in the trade or business, or whether there were instances in which such animals were held primarily for sale to customers. See *Albright* v. *United States*, 173 F. 2d 339 (C.A. 8th); *United States* v. *Bennett*, 186 F. 2d 407 (C.A. 5th); *Emerson* v. *Commissioner*, 12 T.C. 875; *Fawn Lake Ranch Co.* v. *Commissioner*, 12 T.C. 1139; *Flato* v. *Commissioner*, 14 T.C. 1241; *Kline* v. *Commissioner*, 15 T.C. 998. After the adverse decisions in the *Albright* and *Bennett* cases, *supra*, the Commissioner, in Mim. 6660, 1951-2 Cum. Bull. 60, re-examined his position with respect to Section 117(j) and stated (p. 61):

> It is the present position of the Bureau that gains derived from the sale of dairy, draft, or breeding animals are to be recognized as coming within the purview of section 117(j) of the Internal Revenue Code if the taxpayer establishes that the particular animals sold were actually used for dairy, draft, or breeding purposes for substantially their full period of usefulness. If such animals are sold prior to such full period of usefulness, the taxpayer must show that they were added to the herd for substantial use in such herd and not temporarily with the object in view of an early sale.

The requirement that the animals must be used in breeding for substantially their full period of usefulness gave rise to new difficulties, and in Section 324 of the Revenue Act of 1951, c. 521, 65 Stat. 452 (Appendix, *infra*), Section 117(j) was amended to provide that "property used in the trade or busi-

ness" also included "livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition." [3] The exclusion for property held primarily for sale to customers was, however, equally applicable to livestock under this amendment.

It is apparent from the Senate Report accompanying this legislation (S. Rep. No. 781, 82d Cong., 1st Sess., pp. 41-42 (1951-2 Cum. Bull. 458, 487-488) (Appendix, *infra*)) that the language "regardless of age" was inserted into the statute to overcome the effect of Mim. 6660 and to preserve capital gain treatment even though an animal held for breeding purposes was sold before its breeding usefulness had ended. Although the purpose for which the livestock is held is crucial under the statute, Congress did not intend to allow capital gain on the sale of animals which had not yet become a part of the breeding herd. *Gotfredson* v. *Commissioner*, 217 F. 2d 673 (C.A. 6th); *Fox* v. *Commissioner*, 198 F. 2d 719 (C.A. 4th). This distinction is essential to a proper understanding of the present case. The age of the

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[3] Section 324 of the Revenue Act of 1951, which added this provision to Section 117(j), was made applicable to taxable years beginning after December 31, 1941, except that the holding period was extended from 6 to 12 months only with respect to taxable years beginning after December 31, 1950. In the present case, therefore, the taxable years 1948 to 1950 were subject to the 6-month holding period, and 1951, to the 12-month period.

After the enactment of this provision, the Commissioner revoked Mim. 6660. Mim. 6776, 1952-1 Cum. Bull. 71.

heifers is, indeed, unimportant (except for the holding period requirement) once it is determined that they have been introduced into the breeding herd. But to permit the taxpayers to maintain (Br. 27) that all of those animals became part of their breeding herd at birth simply because they ran with the bulls would enable them to treat young and even newborn heifers as a part of the breeding herd even though it is clear a portion was held primarily for sale to customers. This would certainly be beyond the purpose of Congress in amending Section 117(j) in 1951.

Whether livestock is held for breeding purposes or primarily for sale to customers is a question of fact to be determined from all the relevant circumstances. *United States* v. *O'Neill*, 211 F. 2d 701 (C.A. 9th); *Gotfredson* v. *Commissioner*, *supra*; *Fox* v. *Commissioner*, *supra*. The taxpayers were engaged in the business of raising cattle for sale on the beef market. Their income was derived primarily from the sale of steers (R. 142, 442-443) which were sold to cattle buyers after the beef roundup in the Fall of each year (R. 438-439). The gain from the sale of these animals was just as much a part of their ordinary business income as the sale of dairy products is the source of ordinary income from the operation of a dairy herd. *Fox* v. *Commissioner*, *supra*.

When Milford undertook to operate the Vaughan herd in 1946, he soon found that it was impossible for him to operate as economically as the Vaughan Bros. had. Part of this, he testified, was due to the fact that it became necessary to employ and pay a

hired hand to assist him, and part was due to the general rise in living expenses. (R. 290, 291). In addition, the agreement required Milford to pay virtually all expenses connected with the operation of the herd even though he was to receive only one-half the proceeds from cattle sales. (R. 85.) Since the money derived from these sales was his only source of income (R. 289), he had to sell more animals *as beef cattle* in order to obtain operating funds. This became apparent to him in the very first Fall of his management. (R. 335.) Thus, with the assistance each year of one or more of the taxpayers (R. 440), Milford selected and sold heifers as well as steers in the beef market. In 1948, 96 heifers and 301 steers were sold. The next year the number of heifers sold increased to 207, while steers totaled 287. In 1950, Milford sold 245 heifers and 289 steers. (R. 443.) As the Tax Court stated (R. 452), "The number of heifers sold each year was determined by the anticipated requirement by Milford of operating funds for the coming year." The percentage of heifer sales to total sales during the period 1948-1950 increased from 20% to 37% (R. 442), so that it is apparent that a substantial part of the yearly income derived from the operation of the herd is attributable to this source. Moreover, the sale of heifers was not an unprofitable endeavor, for as Mr. Anderson, a cattle buyer and feeder, testified, this part of the State of Idaho "has always been a heifer area" (R. 384); he himself purchased primarily cows and heifers for his meat packing business rather than steers (R. 383).

The taxpayers concede (Br. 25) that the reason heifers were sold during the contract term was to provide Milford with operating funds. What they fail to perceive is the effect this fact has on their claim (Br. 27) that all heifers in the herd were held for breeding purposes from birth. We do not question that a portion of all the animals was held for breeding purposes. The Tax Court explicitly found that all bulls and cows culled from the herd were held for breeding purposes (R. 441), as well as those heifers over 24 months of age (R. 443). But the need for operating funds was such that the younger heifers were held for the same reason as the steers; namely, for sale on the beef market in the ordinary course of the taxpayers' operations. Compare *Cole* v. *United States*, 138 F. Supp. 186 (E. D. Ill.). An animal is not necessarily a member of the breeding herd merely because it is suitable for that purpose, or even because negligible breeding use may be made of it. Treasury Regulations 111 (1939 Code), Section 29. 117-7(c) (Appendix, *infra*).

The taxpayers contend that it was their intention to restore the herd to its original size, and that Milford treated all heifers as members of the breeding stock so that he could obtain a herd of his own at the end of the contract term. (Br. 24, 27.) Their intention, however, is unsupported by the record facts. During the term of the agreement with Milford, the number of animals increased from 1,520 to 1,837 (R. 434, 444), considerably less than the operating capacity of the ranch, which was 2,100 animals (R.

437). Heifers branded during the same period totalled 1,636 animals; yet fully one-third of these were sold between 1948 and 1950 as beef cattle. (R. 443, 450.) In other words, the taxpayers were selling in the ordinary course of business a substantial part of the very same animals which they acknowledge (R. 161-162) were essential if the herd was to increase.

Additional support for the decision below can be drawn from the manner in which the heifers were selected for sale. The Tax Court found (R. 452) that "The designation of particular animals to be sold was based upon a determination of which animals buyers would purchase." The overriding element was the need for operating funds. As Milford testified (R. 289), after the income from the sale of steers and culled cows had been computed, it was necessary to sell heifers as well. He clearly stated (R. 357) that he was forced to sell even "good heifers"—that is, heifers which were otherwise suitable for introduction into the breeding herd. Mr. Anderson testified (R. 389) that he would not purchase any heifers which were carrying unborn calves, and his testimony is supported by that of F. C. Vaughan (R. 425). The heifers sold were not culled from the herd because they were unsuitable for retention, as in *McDonald* v. *Commissioner*, 214 F. 2d 341 (C.A. 2d), a case heavily relied upon by the taxpayers. (Br. 17-18, 29.) Instead, they were selected according to their desirability by the prospective purchasers. *Clark* v. *Commissioner*, 27 T.C. 1006, 1012.

In the absence of sufficient evidence to ascertain the reason for which each animal was held, the Tax Court, following *Fox* v. *Commissioner*, *supra*, separated the heifers at the 24-month age. However, this point of demarcation was not arbitrarily chosen. Milford testified (R. 344) that a heifer usually commences breeding at about 14 or 15 months. Since the gestation period lasts nine months (R. 438), most heifers did not produce a calf until they were approximately two years old. He also stated (R. 345-346) that a heifer can be considered a useful member of the herd at that age. In addition, the Tax Court found (R. 439) that "The characteristics upon which a determination is made as to whether a heifer will be valuable as a replacement in the herd do not develop until the heifers are 18 to 24 months old." F. C. Vaughan stated (R. 412) clearly that the culling of heifers was not satisfactory until they were 15 to 23 months old. This effectively disposes of taxpayers' argument (Br. 29) that mere exposure to the bulls at an earlier age was equivalent to holding these animals for breeding purposes. Thus, in the light of these and the other factors mentioned below, it is clear that until they reach the age of 24 months, the heifers could not be considered as being held for breeding purposes. See also, *Gotfredson* v. *Commissioner*, *supra*; *Biltmore Co.* v. *United States*, 228 F. 2d 9 (C.A. 4th); *Greer* v. *Commissioner*, 17 T.C. 965, 972-973. Ordinarily, the purpose for which an animal is held is shown by its use (Treasury Regulations 111 (1939 Code), Section 29.117-7(c)), though that is not the sole criterion. In this case, it is clear

that most heifers would not produce a calf—and thereby increase the size of taxpayers' herd—until they were two years old. (R. 243.) Exposure to the bulls from birth is particularly insignificant here because this herd was run as an open range operation; since no fences were used, segregation of the heifers from the bulls was impossible. (R. 437-438.) Taxpayers' contention that the heifers were always held for breeding purposes simply cannot be sustained on the fact of exposure alone. Moreover, it is clear that there was nothing to indicate that the heifers which Milford sold were pregnant for had they been there would have been no market for them as beef cattle. (R. 438-439.)

The principal cases relied upon by the taxpayers (Br. 15-22) are distinguishable. In some of them (*Albright* v. *United States*, 173 F. 2d 339 (C.A. 8th); *United States* v. *Bennett*, 186 F. 2d 407 (C.A. 5th)) the animals were culled from a dairy herd or breeding herd and sold after their usefulness therein had ended. In others (*McDonald* v. *Commissioner*, *supra; Miller* v. *United States*, 98 F. Supp. 948 (Neb.)), they were removed from the breeding herd because they were physically inferior to animals of a similar age. In *Pfister* v. *United States*, 102 F. Supp. 640 (S. Dak.), the District Court concededly held that heifers were members of the breeding herd from birth. However, the appellate opinion (*United States* v. *Pfister*, 205 F. 2d 538, 542 (C.A. 8th)) seems to state quite clearly that the taxpayer maintained two herds, one for breeding and one for sale

in the ordinary course of business. Similarly, in *Estate of C. A. Smith* v. *Commissioner*, 23 T.C. 690, the taxpayer maintained two herds, and it was undeniable that the animals sold came from the breeding herd alone. In *O'Neill* v. *United States*, (S. D. Cal.), decided June 16, 1952 (52-2 U.S.T.C., par. 9462), affirmed *per curiam*, 211 F. 2d 701 (C.A. 9th), the heifers were intended for breeding at the age of two years as in prior years, but were sold because of inadequate rainfall after they reached that age. In the case at bar, the younger heifers were not hold for breeding purposes until they were 24 months of age, but on the contrary were intended to be sold so as to permit the payment of operating expenses.

Taxpayers also contend (Br. 31-39) that the heifer sales in 1951, at the end of their contract with Milford, constituted a partial liquidation of the herd so that capital gain treatment is required.

In January, 1951, the taxpayers and Milford began to divide the animals in accordance with the terms of their agreement. This task was completed in April of the same year. However, the taxpayers did not have sufficient land to run all of the cattle to which they were entitled. A search to find suitable facilities had been fruitless, and no agreement could be reached with Milford to accommodate a part of the cattle. (R. 443-444.)

Accordingly, the taxpayers had to sell some of the livestock. In the first four months of 1951, Milford purchased from them a number of cows, bulls, steers and suckling calves. He also purchased one group of

50 heifers that were 20 to 24 months old, and another group of 170 heifers, ranging from 12 to 18 months of age. The Tax Court found that only the cows and bulls were held for breeding purposes. (R. 444.)

The taxpayers had also removed a number of animals to Oregon where they owned another ranch (R. 200), and where they also leased additional land (R. 201). Of these animals, they subsequently sold 202 cows and 100 suckling calves to Mr. Barlow, a cattle rancher. (R. 201-202.) They also sold to Robert F. Vaughan [4] 52 steers, and 60 heifers ranging in age from 12 to 15 months. The Tax Court found that only the cows sold to Barlow were held for breeding purposes. (R. 444-445.)

All of the heifers sold to Milford and to Robert F. Vaughan were 12 to 24 months old, so that they had been managed by Milford for at least a year before the taxpayers disposed of them. Like the heifers of similar ages sold from 1948 to 1950, these animals were not held for breeding purposes until they reached the age of 24 months. The fact, upon which the taxpayers so strenuously rely, that they were forced to sell these animals is of no material consequence. The immediate reason for sale is not the crucial factor; the essential question is the reason for which the animals were held *prior* to sale. Ordinary inventory or stock in trade is not converted into a capital asset simply because the taxpayer finds himself unable to retain it. *Grace Bros.* v. *Commis-*

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[4] He was a son and brother to the taxpayers, but is not a party to this action. (R. 210.)

sioner, 173 F. 2d 170, 178 (C. A. 9th). What was sold here in 1951 was not a partnership interest (*Hatch's Estate* v. *Commissioner*, 198 F. 2d 26 (C. A. 9th) but individual assets held by the partnership. See *Williams* v. *McGowan*, 152 F. 2d 570 (C. A. 2d). Furthermore, not all of these assets were sold at one time. Under these circumstances, it is essential to look at the character of each item sold. It is in this view of the case that the Tax Court's statement (R. 454) that conditions were the same in 1951 as in earlier years is entirely correct. By focusing on the immediate reasons for sale (Br. 37), the taxpayers have overlooked the fact that these heifers had not yet become members of the breeding herd, but were held primarily for sale to beef cattle buyers. They bore a relation to the breeding members of taxpayers' herd in somewhat the same manner as an orange crop is related to the orange trees from which it comes. Indeed, the Supreme Court has specifically drawn this comparison in *Watson* v. *Commissioner*, 345 U.S. 544, 548, fn. 5, and has approved the approach taken in *Williams* v. *McGowan*, *supra*, whereby the individual assets must be judged against the statutory standard (345 U.S. 544, 551-552). For the same reasons, taxpayers' argument (Br. 33) that the animals were replacements in their herd misses the mark.

These principles also dispose of the "liquidation" cases upon which taxpayers rely. In *Deseret Livestock Co.* v. *Commissioner*, decided March 25, 1953 (P-H Memo T.C., par. 53,093), capital gain was permitted on the sale of heifers not because extraordi-

nary drought conditions required a reduction of the herd, but because these animals were found to be held for breeding purposes prior to the sale. In *Bartlett* v. *Commissioner*, decided September 22, 1955 (P-H Memo T. C., par. 55,259), the heifers sold had earlier been selected for, and added to, the breeding herd. In *Harder* v. *United States*, (E. D. Wash.), decided February 17, 1959 (59-1 U.S.T.C., par. 9364), although the heifers were sold because of poor range conditions before they were actually bred, they had earlier been placed in separate pasture and given special feeding to facilitate conception. They were clearly held for breeding purposes before sale. The distinguishing factor in the present case is that the taxpayers' heifers were not introduced into the breeding herd—despite exposure to the bulls—until they reached the age of 24 months. Until that time, they were held primarily for sale as beef just as the steers were. This finding is based upon substantial evidence described above, and is not clearly erroneous. *United States* v. *O'Neill*, *supra*.

It remains only to comment briefly on two other arguments urged by the taxpayers. They rely upon an early ruling, I.T. 3712, 1945 Cum. Bull. 176, in which the Commissioner stated that if the number of animals sold from a breeding herd exceeded those raised and added to it, the excess would be presumed as held for breeding purposes. I.T. 3712 was issued before Section 117(j) was amended in 1951 to include livestock within the term "property used in the trade or business." After the decisions in *Albright* v. *United States* and *United States* v. *Bennett*, *supra*,

I.T. 3712 was revoked by Mim. 6660, 1952-2 Cum. Bull. 60. Mim. 6660 was itself revoked by Mim. 6776, 1952-1 Cum. Bull. 71, after the 1951 amendment to Section 117(j). More importantly, Mim. 6776 expressly stated that the revocation of Mim. 6660 should not be considered as reinstating I.T. 3712. Taxpayers' argument (Br. 36-37) that the Commissioner's position with respect to herd reductions—as set forth in I.T. 3712—somehow survived its revocation is beyond comprehension. The administrative interpretation embodied in I.T. 3712 simply lost significance in view of the later amendment to the statute itself in 1951.

Finally, the taxpayers point (Br. 38-39) to the recent enactment of Section 1245 in the Revenue Act of 1962, P. L. 87-834, 76 Stat. 960, Section 13, for support. That section is designed to treat as ordinary income the gain on the sale or other disposition of certain depreciable property therein defined. Livestock is expressly excluded. However, in the present case the taxpayers apparently carried their heifers in inventory on the "unit-livestock-price" method. (R. 5, 38.) Treasury Regulations 111 (1939 Code), Section 29.23(l)-10, provide that livestock shall not be depreciated if they are included in an inventory since the reduction in value will be reflected in that inventory. Section 1245 was designed to prevent the conversion of ordinary income into capital gain in situations where excessive depreciation deductions were taken prior to sale. Wholly aside from the exclusion of livestock from the property dealt with in that provision, there simply can be no such conversion

when, as here, the heifers were not even depreciable. Accordingly, the enactment of Section 1245 is without significance insofar as the instant case is concerned. The prime consideration here is still whether the livestock are held for breeding purposes or primarily for sale to customers in the ordinary course of business. The Tax Court has decided the latter with respect to the heifers involved in this review, and the taxpayers have not shown that finding to be clearly erroneous.

CONCLUSION

For the reasons stated, the decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted,

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DECEMBER, 1963.

CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ....day of...................., 1963.

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ALEC A. PANDALEON,
Attorney.

APPENDIX

nternal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade, or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l);

* * * *

(j) [as added by Sec. 151(b) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inven-

tory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

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(26 U.S.C. 1952 ed., Sec. 117.)

Revenue Act of 1951, c. 521, 65 Stat. 452:

Sec. 324. SALES OF LIVESTOCK.

Section 117(j)(1) is hereby amended by adding at the end thereof the following new sentences: "Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry." The first sentence

added to section 117 (j)(1) by the amendment made by this section shall be applicable with respect to taxable years beginning after December 31, 1941, except that the extension of the holding period from 6 to 12 months shall be applicable only with respect to taxable years beginning after December 31, 1950. The second sentence added to section 117(j) by the amendment made by this section shall be applicable only with respect to taxable years beginning after December 31, 1950.

Treasury Regulations 111 (1939 Code):

Sec. 29.117-7 [as amended by T. D. 5970, 1953-1 Cum. Bull. 183]. *Gains and Losses from Involuntary Conversions and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

* * * *

(c) *Livestock held for draft, breeding, or dairy purposes.*—For the purpose of this section, the term "livestock" shall be given a broad, rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. It does not include chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.

The determination whether or not livestock is held by the taxpayer for a draft, breeding, or dairy purpose depends upon all of the facts and circumstances in each particular case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, or dairy purpose may be present in a case where the animal is disposed

of within a reasonable time after its intended use for such purpose is prevented by accident, disease, or other circumstance. An animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may, depending upon the circumstances, be considered held for a draft, breeding, or dairy purpose. An animal is not held by the taxpayer for a draft, breeding, or dairy purpose merely because it is suitable for such purpose or because it is held by the taxpayer for sale to other persons for use by them for such purpose. Furthermore, an animal held by the taxpayer for other purposes is not considered to be held for a draft, breeding, or dairy purpose merely because of a negligible use of the animal for such purpose or because of the use of the animal for such purpose as an ordinary or necessary incident to the purpose for which the animal is held.

These principles may be illustrated by the following examples:

Example 1. An animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile, and is disposed of within a reasonable time thereafter. This animal was held for breeding purposes.

Example 2. The taxpayer retires from the breeding or dairy business and sells his entire herd, including young animals which would have been used by him for breeding or dairy purposes if he had remained in business. These young animals were held for breeding or dairy purposes.

Example 3. A taxpayer in the business of raising hogs for slaughter customarily breeds

sows to obtain a single litter to be raised by him for sale, and sells these brood sows after obtaining the litter. Even though these brood sows are held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business, they are considered to be held for breeding purposes.

Example 4. A taxpayer in the business of raising horses for sale to others for use by them as draft horses uses such horses for draft purposes on his own farm in order to train them. This use is an ordinary or necessary incident to the purpose of selling such animals, and, accordingly, these horses are not held for draft purposes.

Example 5. The taxpayer is in the business of raising registered cattle for sale to others for use by them as breeding cattle. It is the business practice for the cattle to be bred, prior to sale, in order to establish their fitness for sale as registered breeding cattle. In such case, those cattle used by the taxpayer to produce calves which calves are added to the taxpayer's herd (whether or not the breeding herd) are considered to be held for breeding purposes; the breeding of other cattle is an ordinary or necessary incident to the holding of such other cattle for the purpose of selling them as registered breeding cattle, and the breeding of such cattle does not demonstrate that the taxpayer is holding the cattle for breeding purposes.

Example 6. A taxpayer, engaged in the business of buying cattle and fattening them for slaughter, purchased cows with calf. The calves were born while the cows were held by the tax-

payer. These cows were not held for breeding purposes.

S. Rep. No. 781, 82d Cong., 1st Sess., pp. 41-42 (1951-2 Cum. Bull. 458, 487-488):

8. *Gains from sales of livestock*

Section 117(j) of the code provides, in effect, that a net gain from sales of "property used in the trade or business" of a taxpayer and held for more than 6 months is to be treated as capital gain. In the case of a loss, it is to be treated as an ordinary loss. However, section 117(j) states that this treatment is not to apply to "property of a kind which would be properly includible in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." In the case of farmers there has been considerable confusion and dispute for several years as to whether all livestock held for draft, dairy, or breeding purposes is "property used in the trade or business," or whether in some cases the livestock should be deemed held "primarily for sale to customers in the ordinary course of his trade or business."

Rulings of the Treasury Department issued in 1944 and 1945 held that the capital gains treatment was applicable only in the case of unusual sales such as those which would reduce the normal size of the herd or those resulting from a change of breed or other special circumstances, and that the capital gains treatment would not apply to the customary sale by a farmer of old or disabled animals culled from the breeding

herd and replaced by young animals produced by the breeding herd. Early in 1949 the United States Court of Appeals, Eighth Circuit, held in the *Albright* case (173 F. 2d 339) that animals used for breeding purposes, whether or not sold as culls in the ordinary course of business, constituted "property used in the trade or business" within the meaning of section 117(j). That decision specifically applied to dairy cattle and hogs but was applicable by implication to other types of livestock.

Notwithstanding the *Albright* decision, the Treasury Department continued to adhere to its position initiated in the 1944 and 1945 rulings, pending possible contrary decisions in other courts which might result in a conclusive decision by the Supreme Court. The Revenue Act of 1950 as passed by the Senate contained a provision intended to clarify this situation, but this was rejected in conference, principally because it referred to "cattle" and thus did not clear up the situation with respect to other forms of livestock such as sheep and hogs. However, the conference committee expressed the hope that the Treasury would follow the *Albright* decision.

In January 1951 the United States Court of Appeals, Fifth Circuit, decided the *Bennett* case (186 F. (2d) 407) in a manner similar to the *Albright* decision. Subsequently the Bureau of Internal Revenue issued a ruling, Mim. 6660, stating that the capital gains treatment provided by Section 117(j) would be applied to sales of culls. However, this ruling contained a statement that this treatment might not be applied in the case of animals "not used for substantially their

full period of usefulness." This exception appears to have resulted in new uncertainties, and it has been stated that Bureau agents are interpreting this ruling to mean that only animals which have completely outlived their usefulness can qualify for the capital gains treatment.

The House bill added a new sentence to section 117(j)(1) providing that the term "property used in the trade or business" includes "livestock held by the taxpayer for draft, breeding, or dairy purposes for 12 months or more." In view of the uncertainties resulting from the recent ruling (Mim. 6660), section 324 of your committee's bill restates the sentence contained in the House bill as follows:

> Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition.

Under your committee's bill, the term "livestock" does not include poultry except that it does include turkeys, regardless of age, held by the taxpayer for breeding purposes and held for 12 months or more from the date of acquisition. Thus section 117(j) will apply to livestock used for draft, breeding, or dairy purposes, and to turkeys used for breeding purposes, whether old or young; and the holding period will start with the date of acquisition, not with the date the animal or fowl is put to such use.

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